How low can sterling go?

TREVOR WILLIAMS ASSESSES THE OUTLOOK FOR A WEAK POUND AND ITS LIKELY IMPACT ON CORPORATE BRITAIN.

Executive summary

- Sterling has fallen sharply over the past year. What is going on? How low can sterling go against the dollar and the euro? What could be the implication for price inflation and hence for monetary policy?

Sterling is down by more than 20% on the trade-weighted index (TWI) over the past year, but its fall against the dollar and the euro has been as deep or even deeper – close to 25%. In the past, sterling declines of this order would rapidly lead to rising prices and a subsequent rise in interest rates to control them, which would weaken the economy and so help keep inflation pressure in check. However, the Bank of England's view is that inflation will remain low this time because:

- the economy is in recession, making it very difficult for price rises to be passed on by firms (although this may mean profits will fall and unemployment will therefore end up higher than otherwise);
- commodity prices are now falling after record highs in 2008; and
- wage inflation is receding, as unemployment rises and employment prospects dim.

TIDE OF OVERSEAS INFLOWS RECEDES The UK has been running a trade and current account deficit for some years, which means that inflows of capital from abroad are required to balance its external accounts. But with short and long-term interest rates having fallen and the issue of gilts likely to rise sharply in the year ahead, as the UK government spends and borrows more to help offset the economic recession and unglue credit markets, the returns for foreign investors have fallen. Their appetite for UK gilts and bonds has also waned, so the exchange rate has fallen, partly to make these assets cheaper and so more attractive in foreign currency terms. With the prospect of further interest rate cuts and increased government spending still high, the UK pound is depreciating in anticipation. Given these trends, how much further can the pound fall against the US dollar and the euro? These currencies account for nearly 70% of UK exports and imports, and therefore largely determine the path the trade-weighted index (TWI) takes going forward.

LONG-RUN VARIABLES CHANGE DIRECTION Six key variables are critical to the long-run direction of the TWI:

- short-term interest rate differences;
- long-term interest rate differences;
- inflation rate differences;
- differences in productivity;
- current account positions; and
- budget deficits.

Other factors also affect a currency's value – the political climate, the willingness to accept foreign investment and investment flows – but these are difficult to model or show a relationship that can be depicted clearly in statistical estimates.

Almost all of the six key variables that compare the UK economy against the US and the euro zone shows have deteriorated in the last two years. Even where they haven't, there is little or no improvement in the UK's relative performance, leaving a fall in sterling the most likely outcome from where it started two years ago, which was at a high level historically.

In terms of current account deficits, the UK position has worsened versus the US and euro zone in the past two years, and quite sharply versus the latter. Although the UK's fiscal position has improved

Figure 1: Euro/UK interest rates compared with €/£

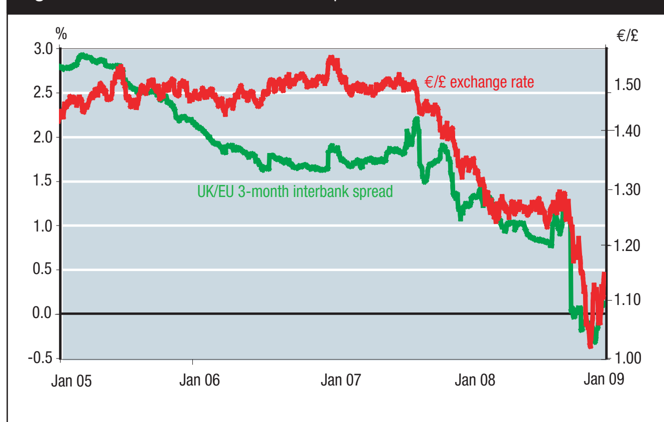
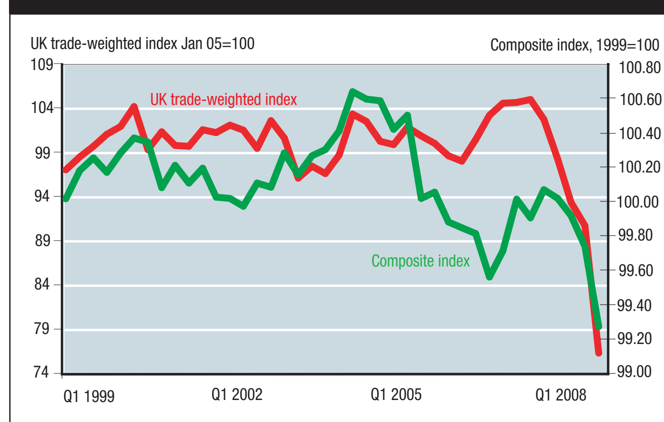


Figure 2: UK trade-weighted index compared with composite index



against the US in the last few years, it has worsened against the euro zone. On the basis of this factor, a fall is more likely in sterling versus the euro than sterling versus the dollar.

In terms of price inflation, the UK has performed well in the last decade on average but in the past two years its inflation rate has risen relative to the US and euro area, although more so against the latter than the former, implying a weaker pound versus the euro. From the perspective of productivity gains, UK performance has generally been good against both economic areas but in the last two years it has also slipped back quite sharply.

In terms of short-term and long-term interest rates, the overall implication is that the UK's exchange rate could fall further. Although there has been some volatility, particularly versus the euro, the fall in the pound appears fully justified by these variables. The UK's usual interest rate premium against the euro has eroded, and what this implies in terms of a weaker currency is most vividly illustrated in Figure 1. The recent fall to record lows in sterling versus the euro should be no surprise. Indeed, if UK short-term interest rates fall further relative to euro rates, there could be fresh lows for the pound against the euro before the year is out.

AGGRESSIVE RATE CUTS ADD DOWNWARD PRESSURE Pulling all these variables together into one indicator (see Figure 2) shows that after being overvalued in the five years to mid-2007, the fall in the UK's TWI has taken it back almost to where a composite index of the six key drivers of its value would suggest it should be. Indeed, on this basis, the recent depreciation of sterling may be overdone, but if the expectations about the extent to which the Monetary Policy Committee may cut interest rates and the budget deficit may widen are proved correct, then the recent market move is simply anticipating these events. However, if UK interest rates are cut more sharply than expected, or price inflation does not fall back as projected in 2009, the pound could fall even further. The UK trade-weighted index could easily drop an additional 10% to 15%. Whatever the outcome, the foreign exchange markets seem to be suggesting that sterling is in for a bumpy ride in the year ahead.

WHAT DOES THIS MEAN FOR UK CORPORATES? The confirmation of the UK's first recession since 1990 coupled with sterling's continued weakness has been weighing heavily on corporate Britain.

In normal times, British manufacturing would be expected to take advantage of a depreciating exchange by selling into overseas markets. However, a sharp slowdown in the UK's main export markets, rising job cuts, falling vacancy levels and continued deterioration in surveys of business conditions in the manufacturing sector suggest that this will prove difficult.

> WITH THE UK IN RECESSION AND CONSUMER SPENDING LIKELY TO REMAIN WEAK AS UNEMPLOYMENT RISES, IT WILL BE SURPRISING IF FIRMS DO NOT TRIM INVESTMENT SPENDING FURTHER THAN THEY ALREADY HAVE.

In an environment of falling corporate earnings and decelerating inflation, corporates have been further hit by the recession in the global economy and the ongoing nature of the credit crisis. This has resulted in rising unemployment, as firms try and cut costs to boost cashflow and so ensure that they survive the financial market crisis and the economic downturn.

Although UK firms started this downturn with better balance sheet strength than their long-run average position, the global nature of the credit market crisis is squeezing their cashflows severely. This could exacerbate their problems, as the number of foreign banks providing loans in the UK has fallen very sharply. Any UK company with dollar or euro creditors could find themselves in serious difficulty.

Business optimism among UK corporates is now close to an all-time low. UK companies are expecting weaker levels of business activity over the next 12 months as economic prospects remain, in their view, poor. With the UK in recession and consumer spending likely to remain weak as unemployment rises, it will be surprising if firms do not trim investment spending further than they already have. We will not see a quick turnaround in this trend any time soon. However, the recent fall in oil prices and some other key commodity prices, alongside lower interest rates and subdued wage inflation, do give reason for hope that pressure on operating margins for UK corporates may start easing by the end of the year.

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